

STRICTLY CONFIDENTIAL (FR) CLASS II-FOMC

Material for

*Staff Presentation to the
Federal Open Market Committee*

February 7, 1989

Basic Assumptions

- Federal Reserve will seek to bring about a gradual reduction of inflation.
- Fiscal policy will be restrictive.
- Crop yields will be normal.
- Energy prices will rise only moderately.

Financial Implications

- Interest rates will rise into early 1990 and then ease a bit.
- M2 will grow roughly 3.5 percent in 1989 and 5 percent in 1990.
- The dollar will fall moderately over the forecast period.

Chart 2

FISCAL POLICY ASSUMPTIONS

For fiscal year 1990, sequester is avoided through a \$27 billion deficit reduction package:

\$20 billion in spending cuts

\$7 billion in user fees and other revenue enhancements.

BUDGET SURPLUS/DEFICIT (-)

Billions of dollars	FY86	FY87	FY88	FY89	FY90
On Budget	-238	-169	-194	-209	-192
Off Budget	17	20	39	49	65
Total	-221	-150	-155	-159	-127

FISCAL IMPETUS

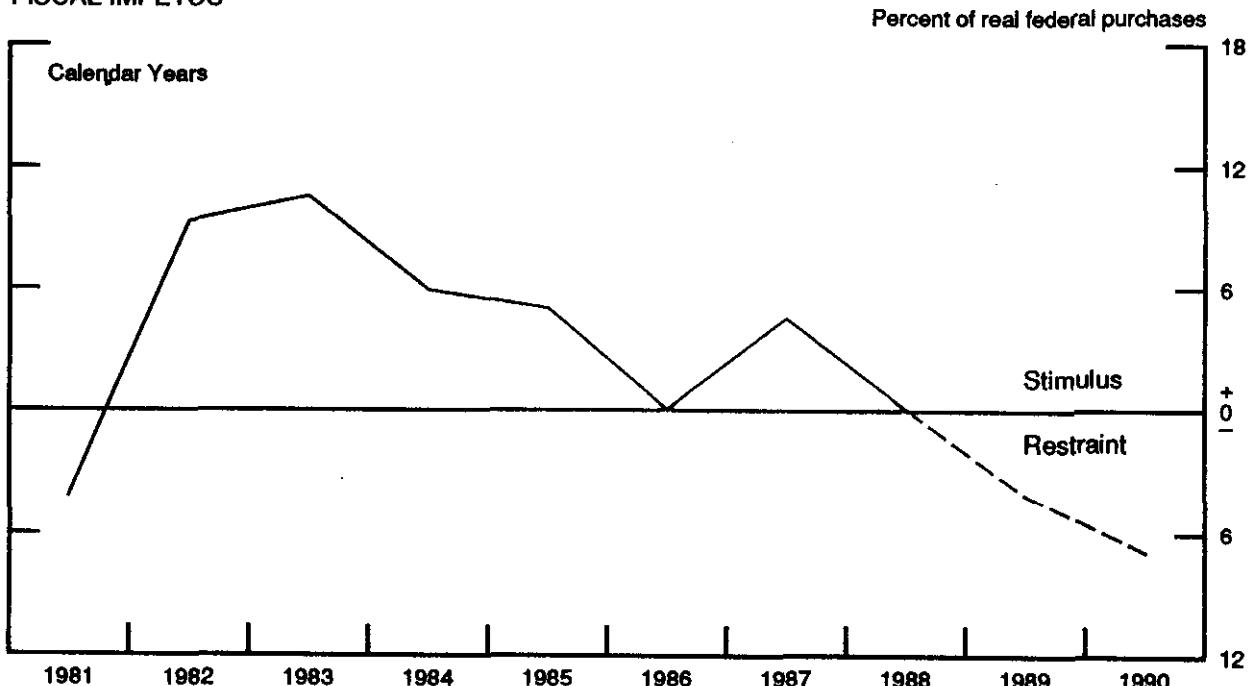
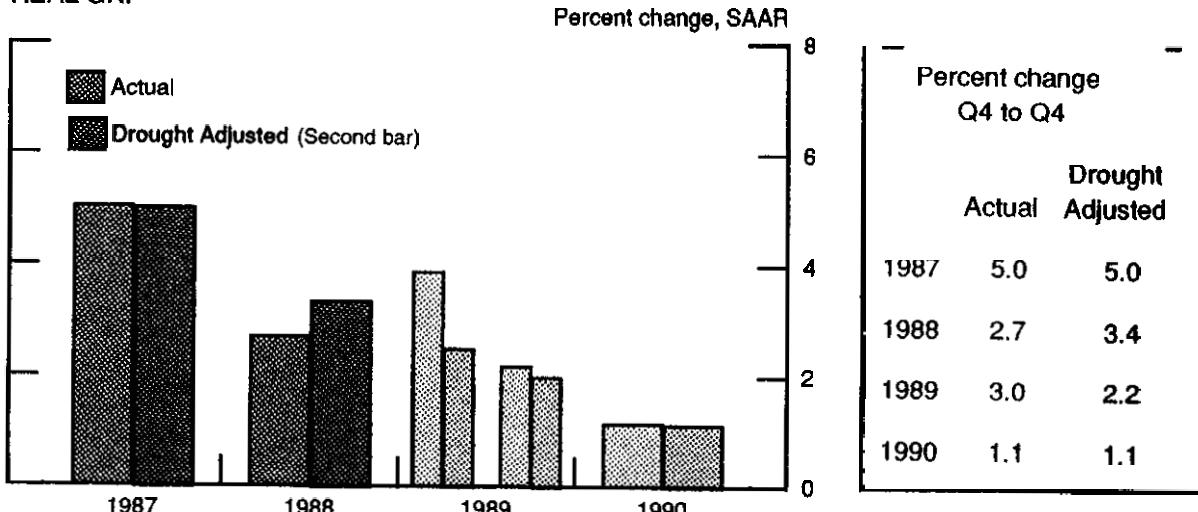
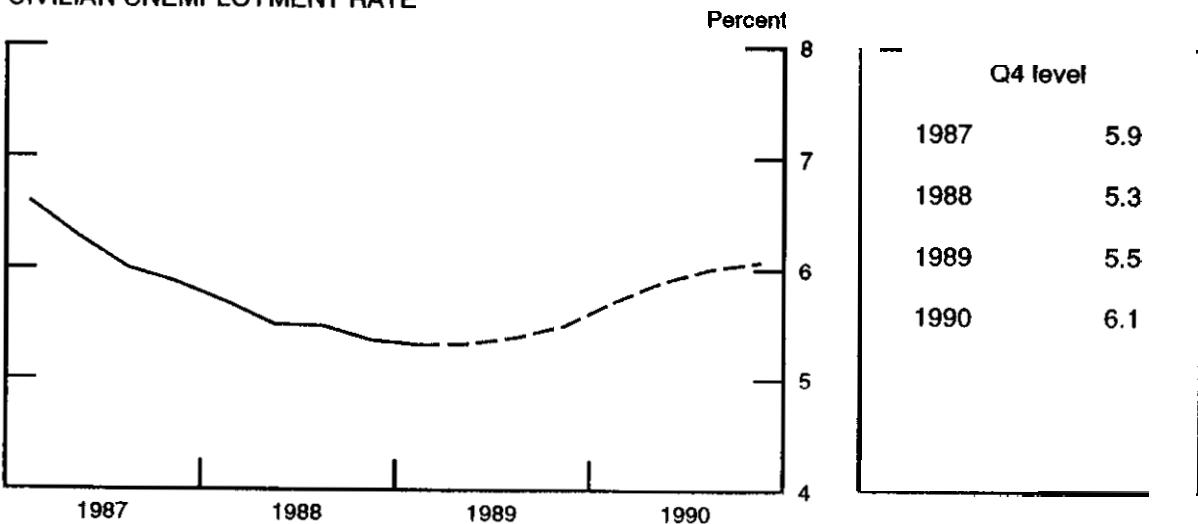


Chart 3
Forecast Summary

REAL GNP



CIVILIAN UNEMPLOYMENT RATE



INFLATION

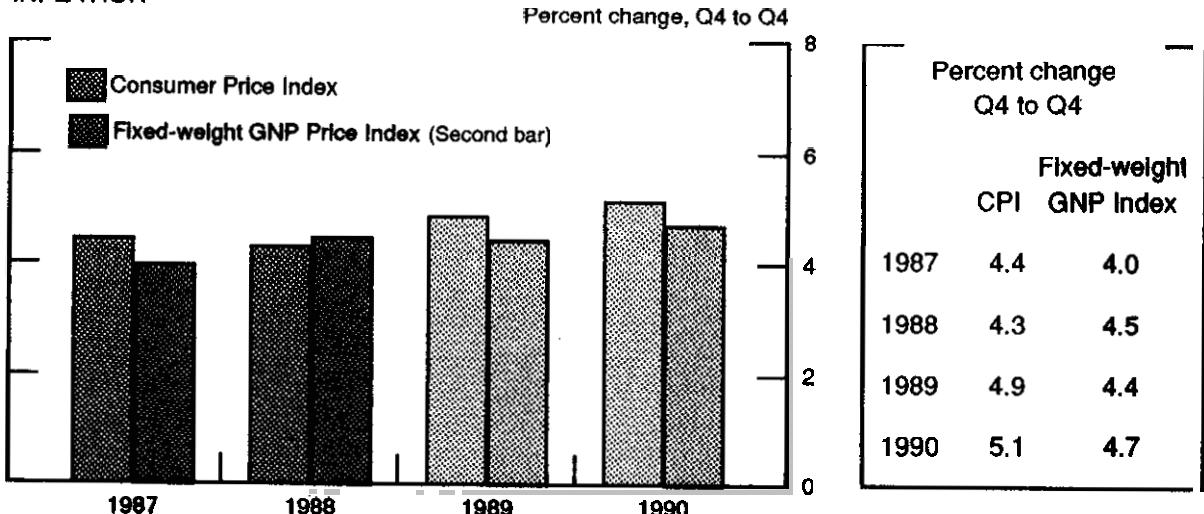


Chart 4

ECONOMIC PROJECTIONS FOR 1989

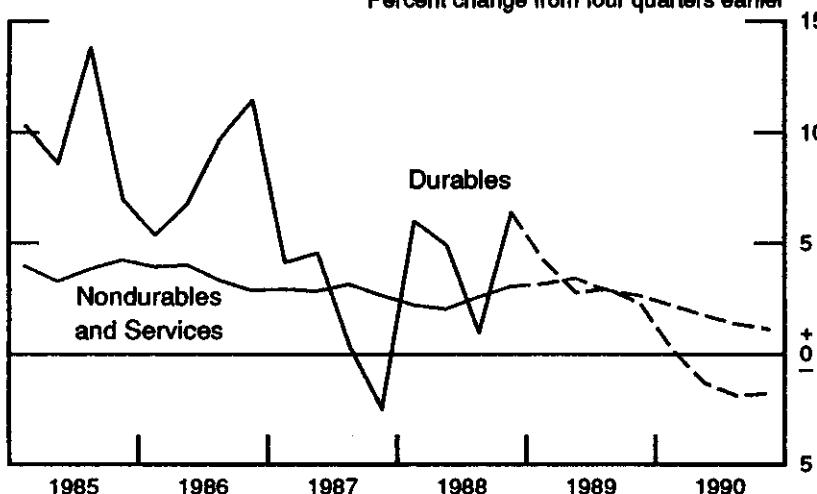
FOMC				
	Range	Central Tendency	Administration	Staff
Percent change, Q4 to Q4				
Nominal GNP	5 1/2 to 8 1/2	6 1/2 to 7 1/2	7.4	7.1
Real GNP	1 1/2 to 3 1/4	2 1/2 to 3	3.5	3.0
CPI	3 1/2 to 5 1/4	4 1/2 to 5	3.6	4.9
Average level, Q4, percent				
Unemployment Rate	5 to 6	5 1/4 to 5 1/2	5.2	5.5

Chart 5

Household Spending

REAL PERSONAL CONSUMPTION EXPENDITURES

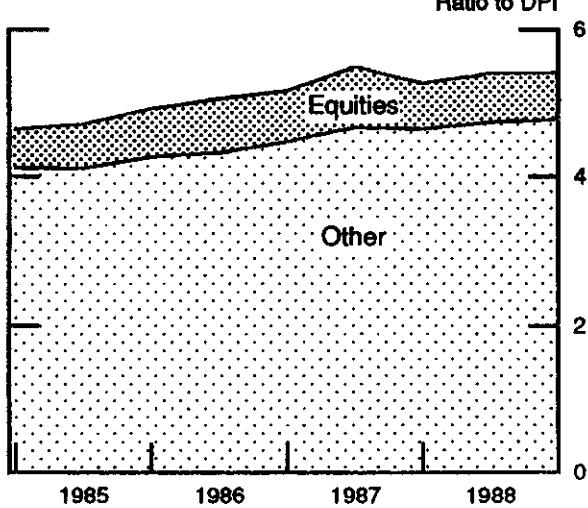
Percent change from four quarters earlier

Percent change
Q4 to Q4

	PCE	DPI
1987	1.8	3.0
1988	3.6	3.8
1989	2.6	2.2
1990	.7	.9

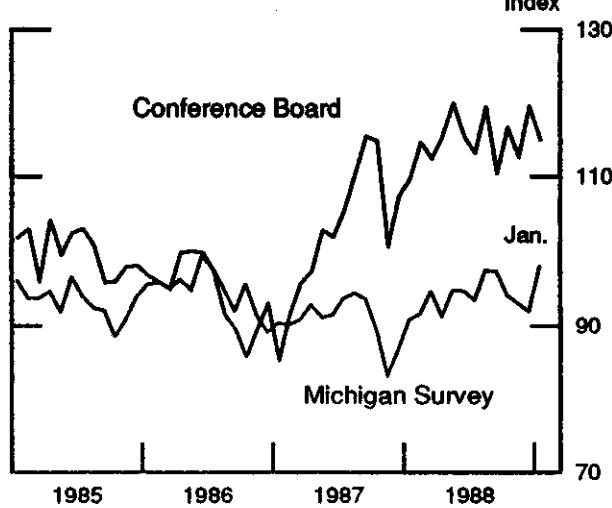
HOUSEHOLD NET WORTH

Ratio to DPI



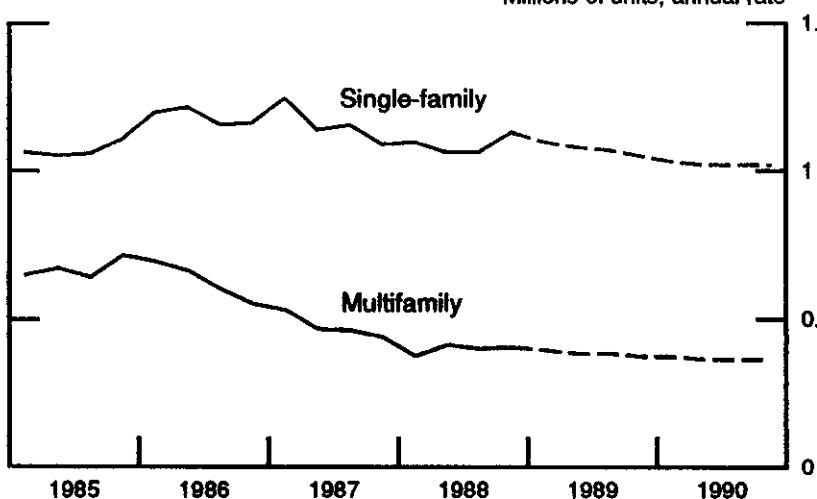
CONSUMER SENTIMENT

Index



HOUSING STARTS

Millions of units, annual rate

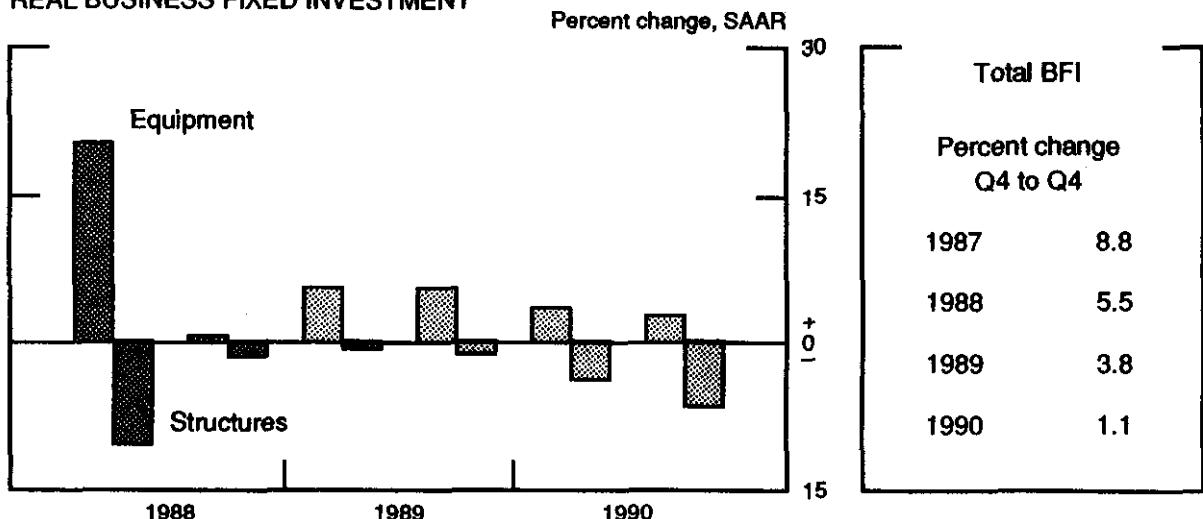
Real Residential
Fixed InvestmentPercent change
Q4 to Q4

1987	-3.5
1988	2.4
1989	-0.9
1990	-1.6

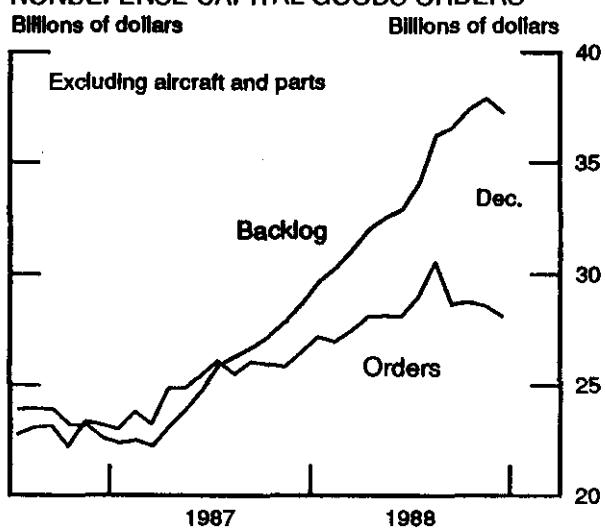
Chart 6

Business Spending

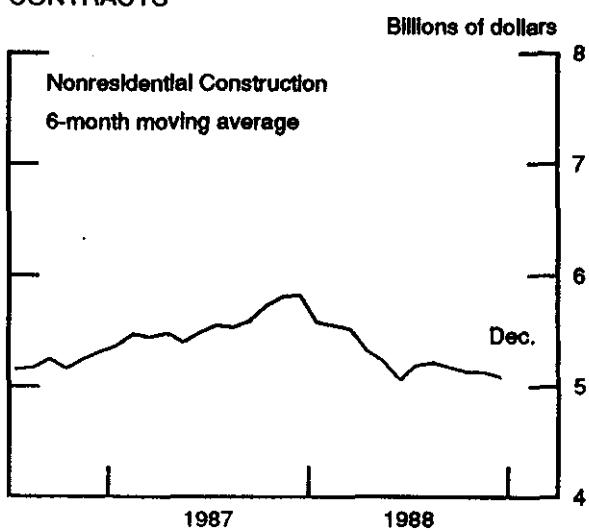
REAL BUSINESS FIXED INVESTMENT



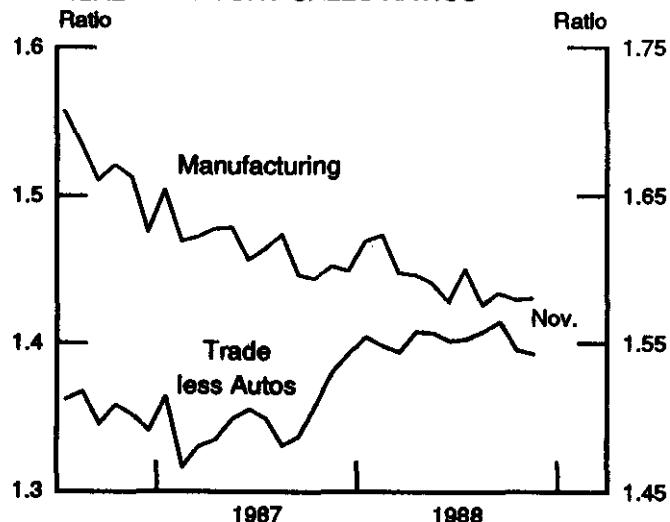
NONDEFENSE CAPITAL GOODS ORDERS



CONTRACTS



REAL INVENTORY-SALES RATIOS



NONFARM INVENTORY INVESTMENT

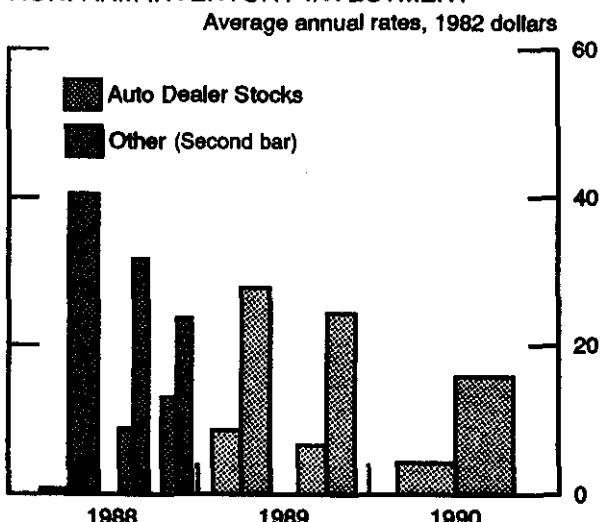
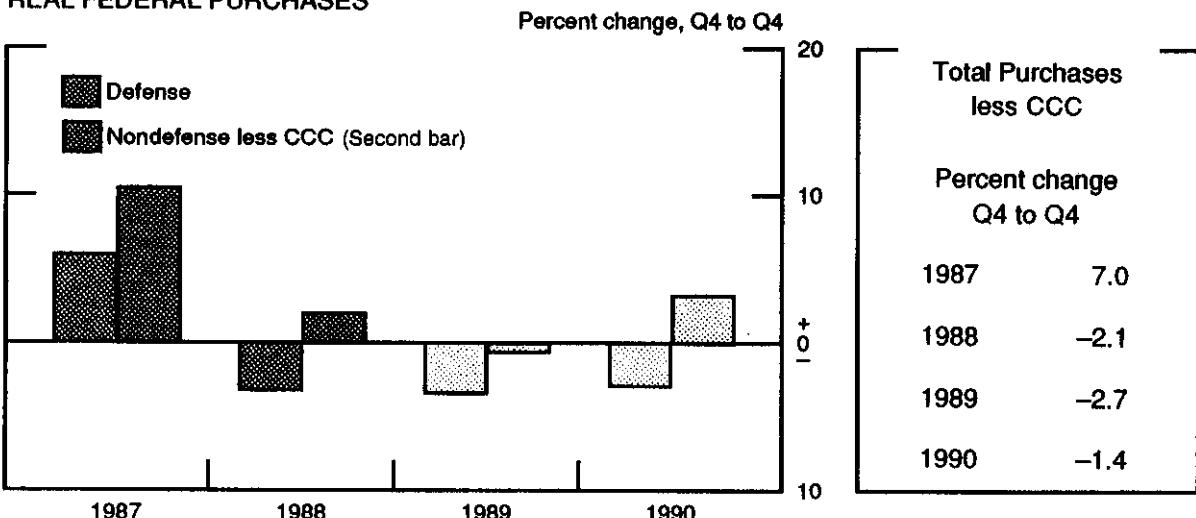


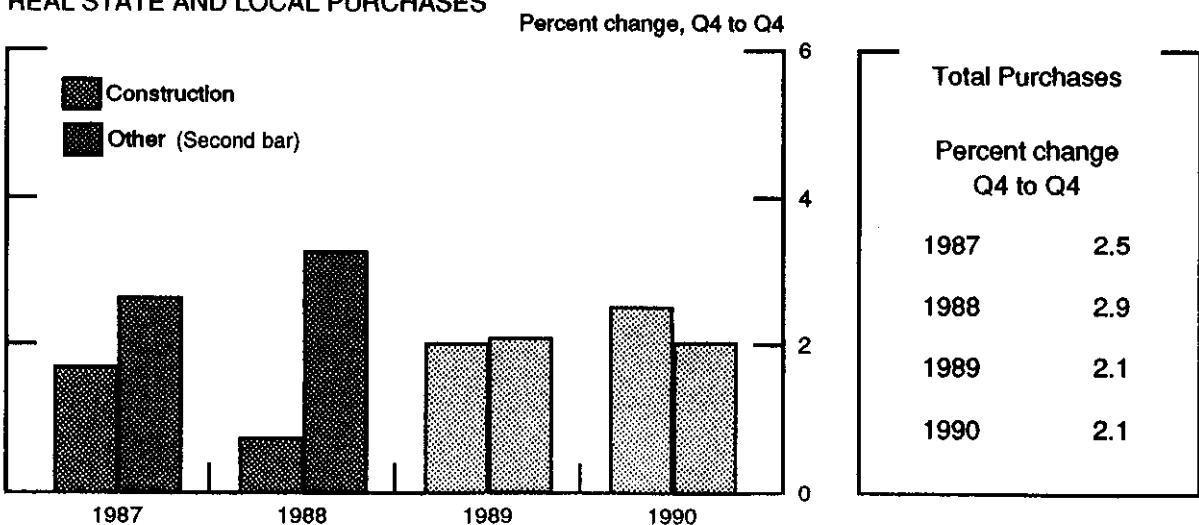
Chart 7

Government Sector

REAL FEDERAL PURCHASES



REAL STATE AND LOCAL PURCHASES



STATE AND LOCAL SURPLUS

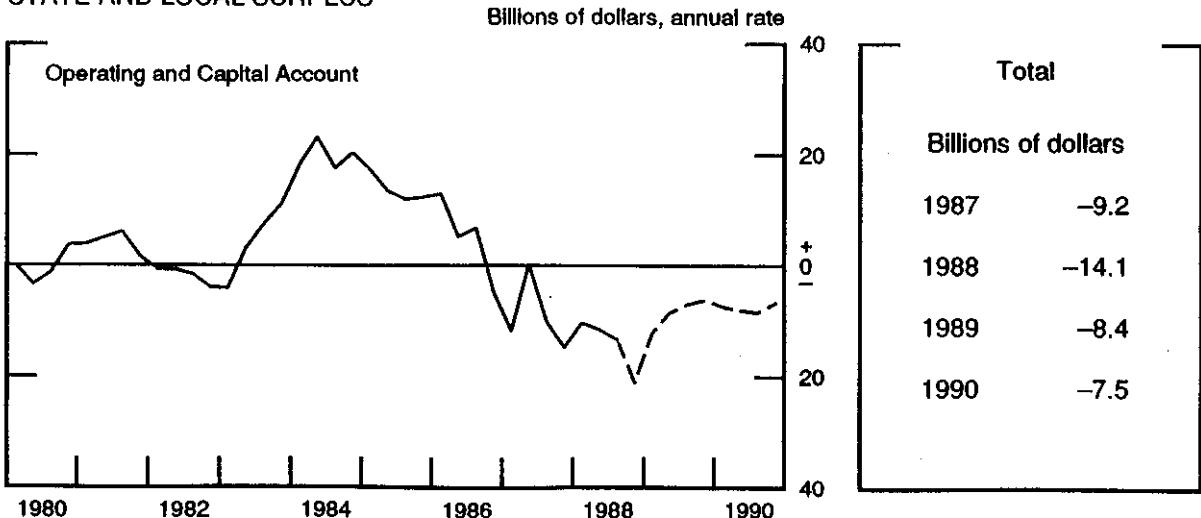
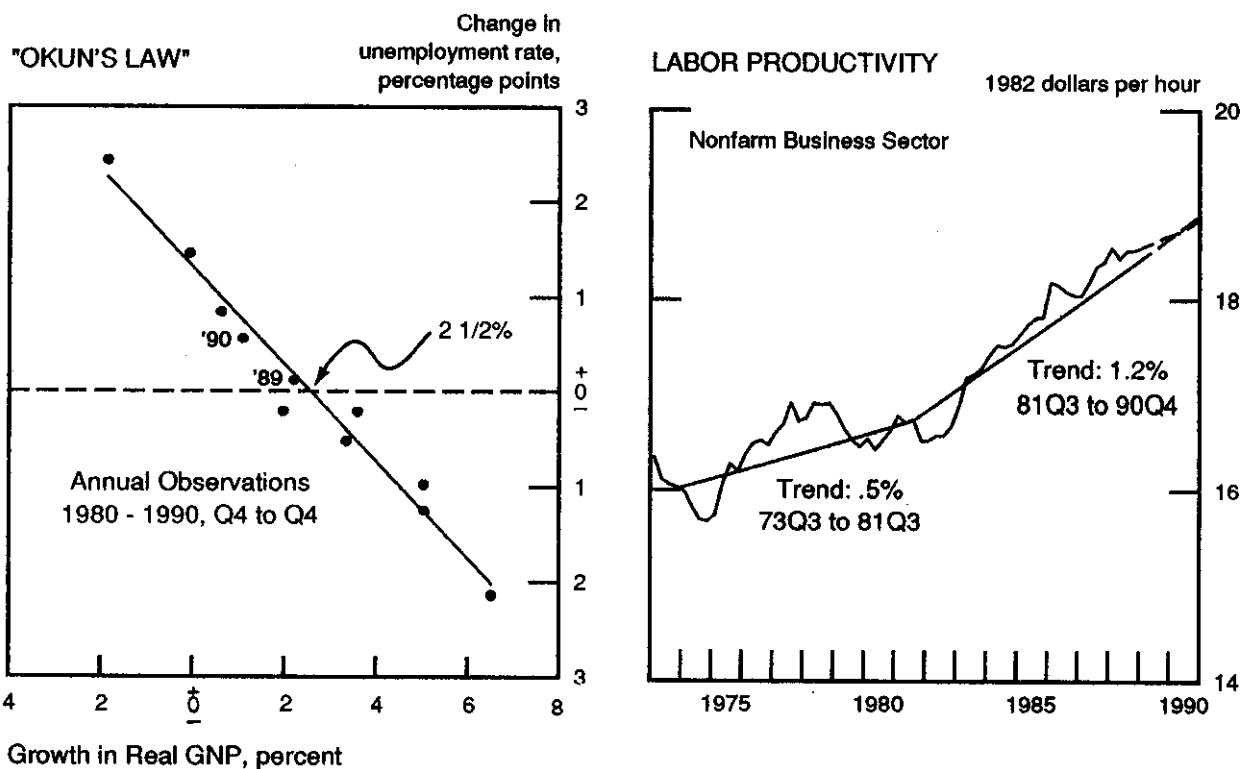


Chart 8

Labor Market



COMPENSATION PER HOUR AND UNIT LABOR COSTS

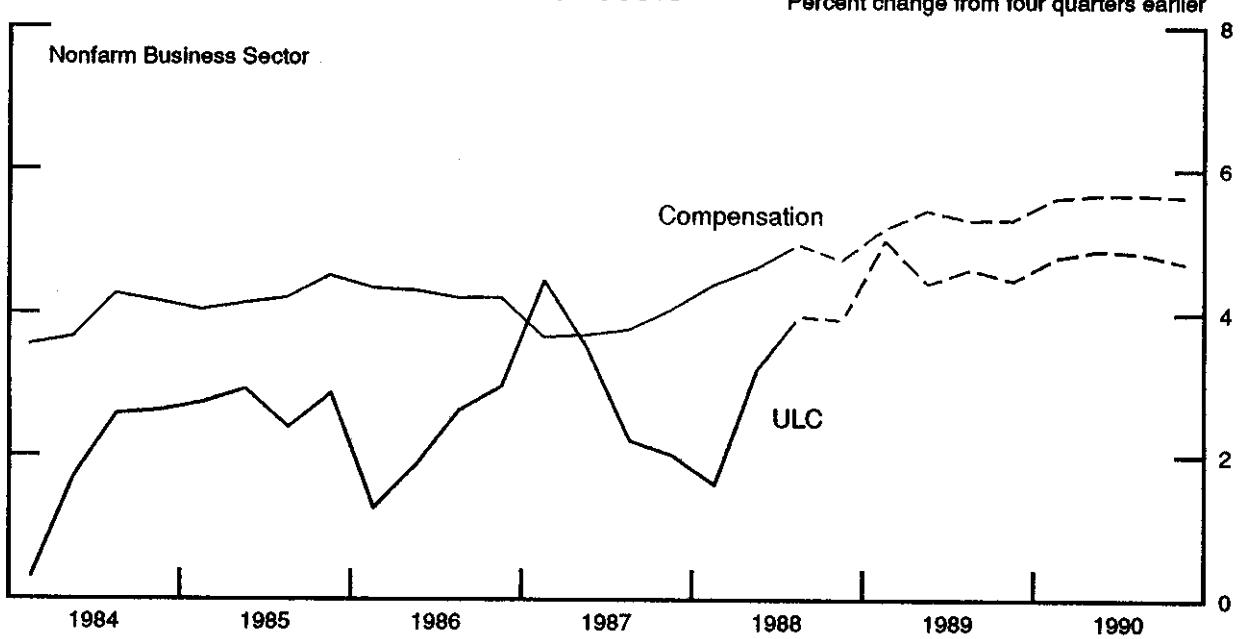
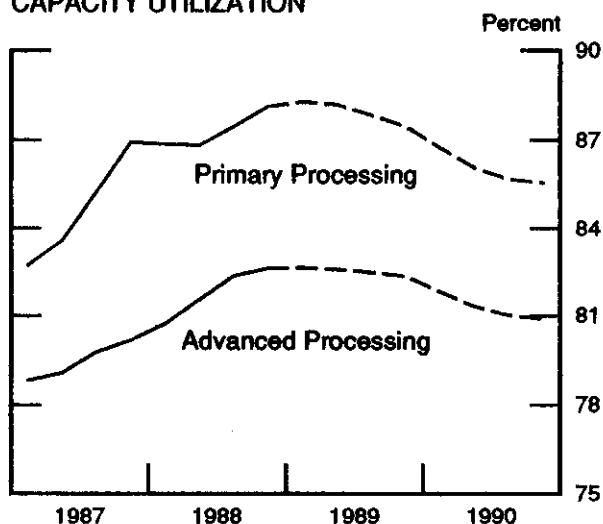


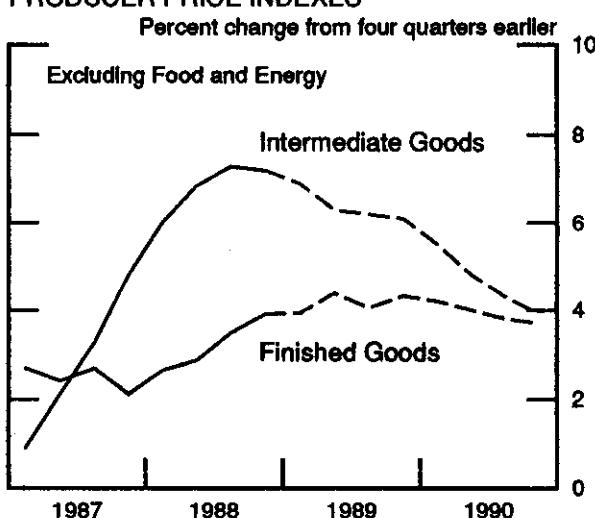
Chart 9

Prices

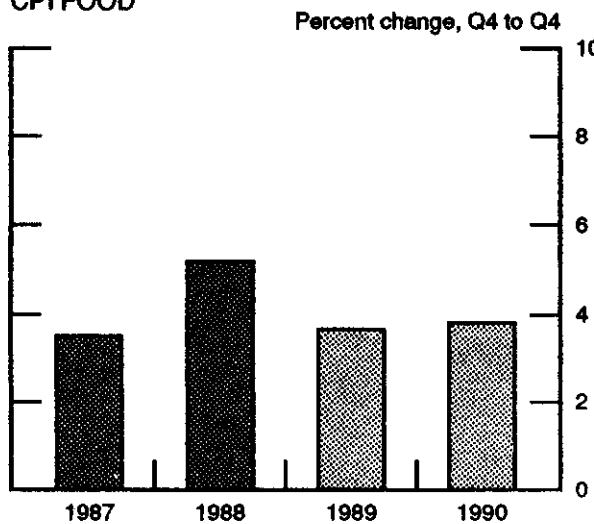
CAPACITY UTILIZATION



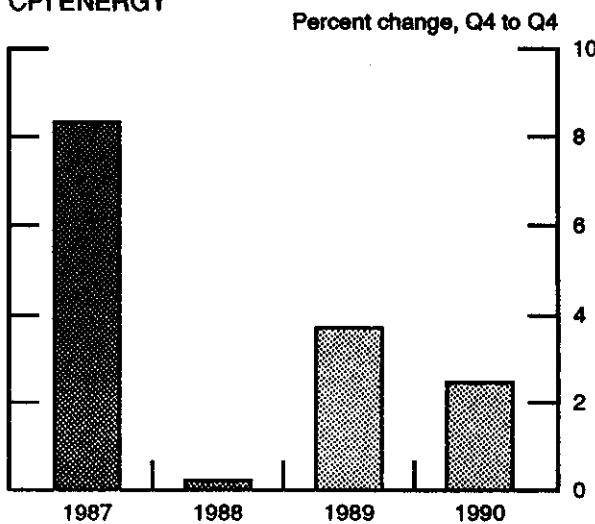
PRODUCER PRICE INDEXES



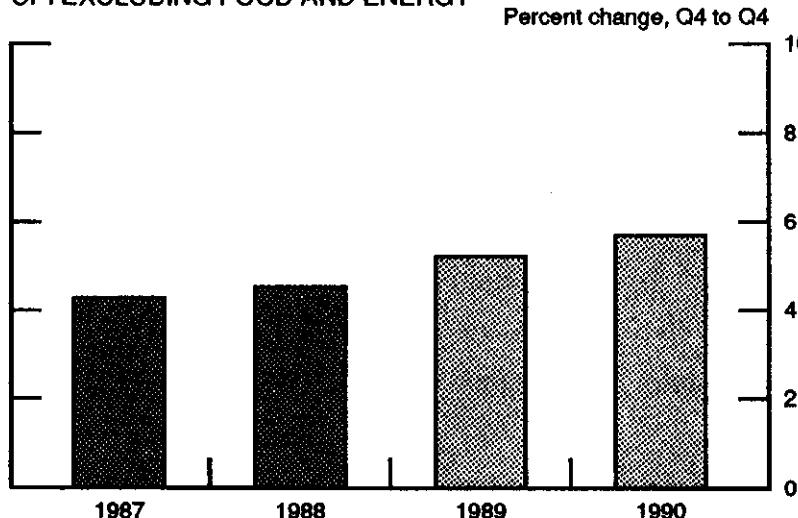
CPI FOOD



CPI ENERGY

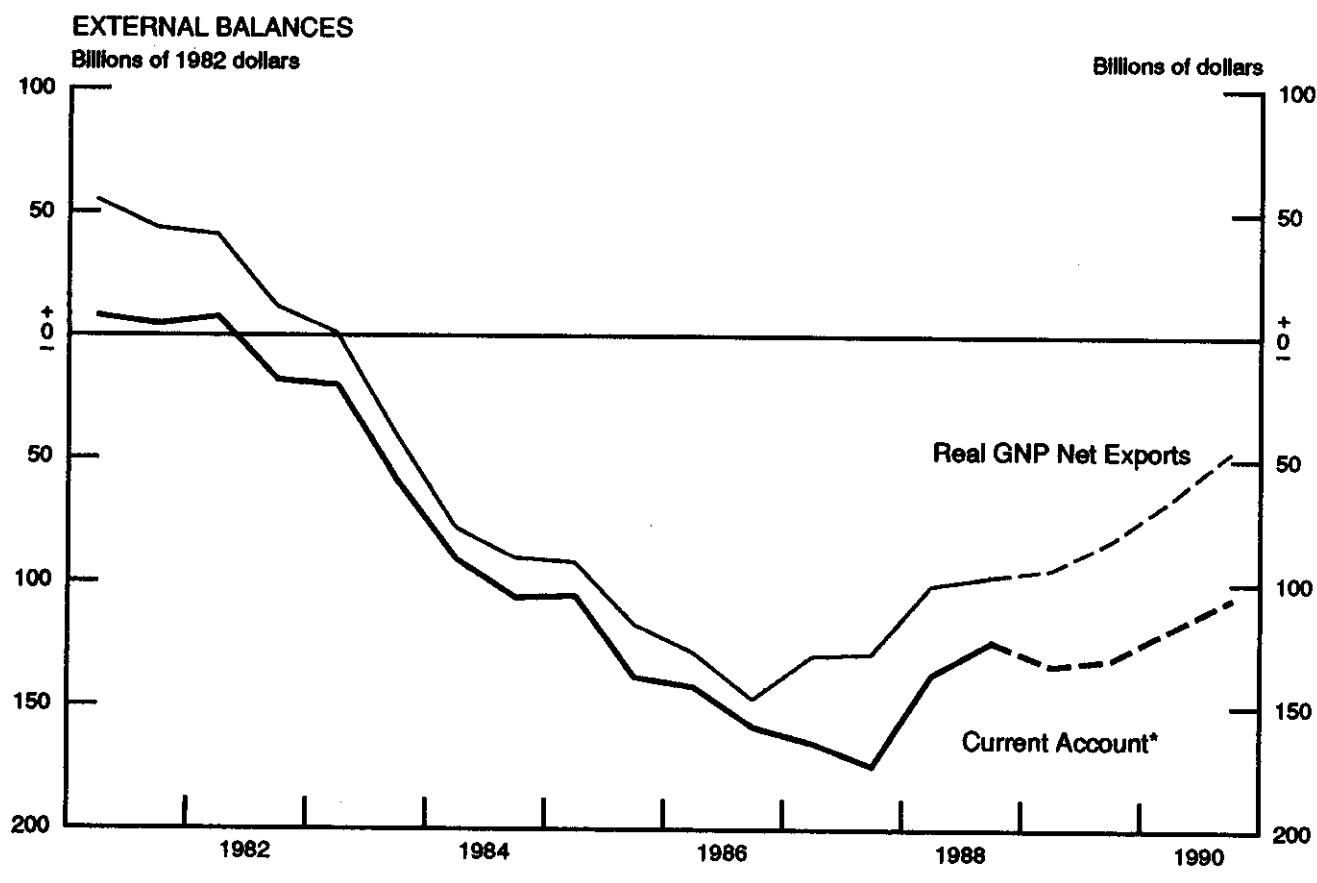


CPI EXCLUDING FOOD AND ENERGY

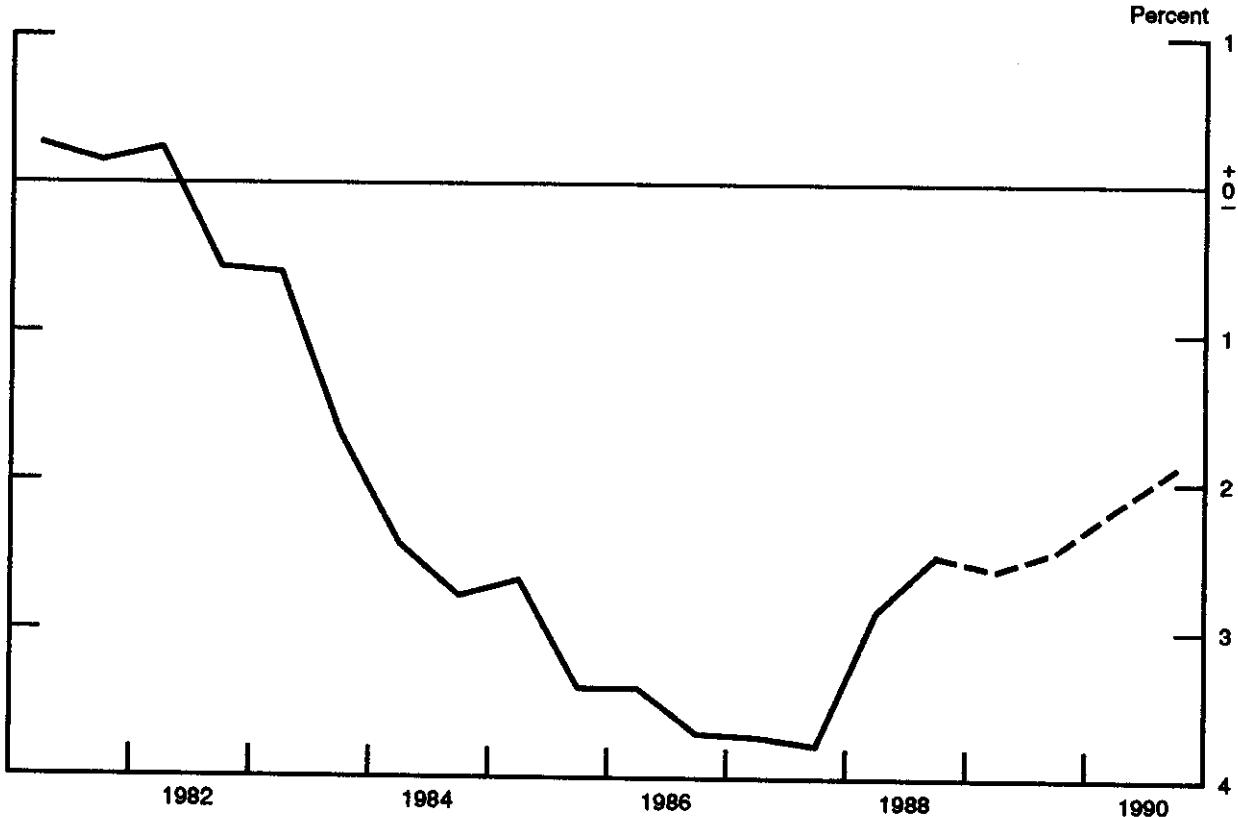


Percent change Q4 to Q4	
1987	4.3
1988	4.5
1989	5.2
1990	5.7

Chart 10



CURRENT ACCOUNT* AS A PERCENT OF GNP

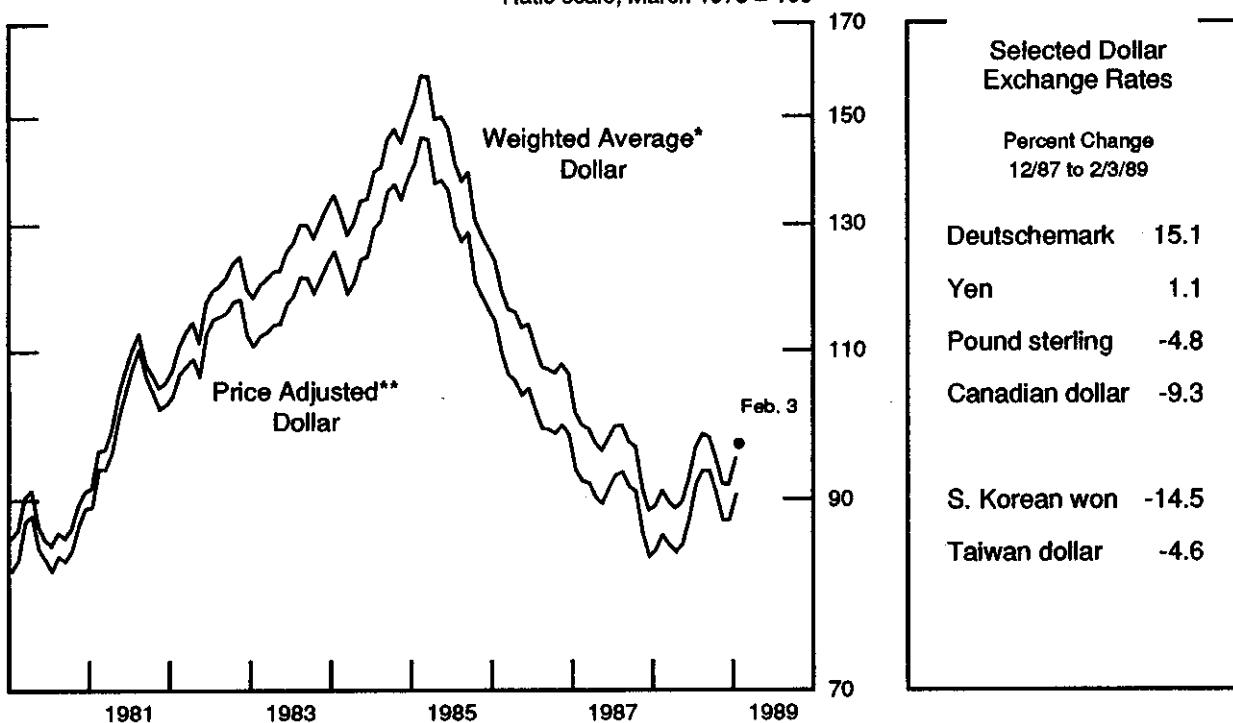


* Excluding capital gains and losses.

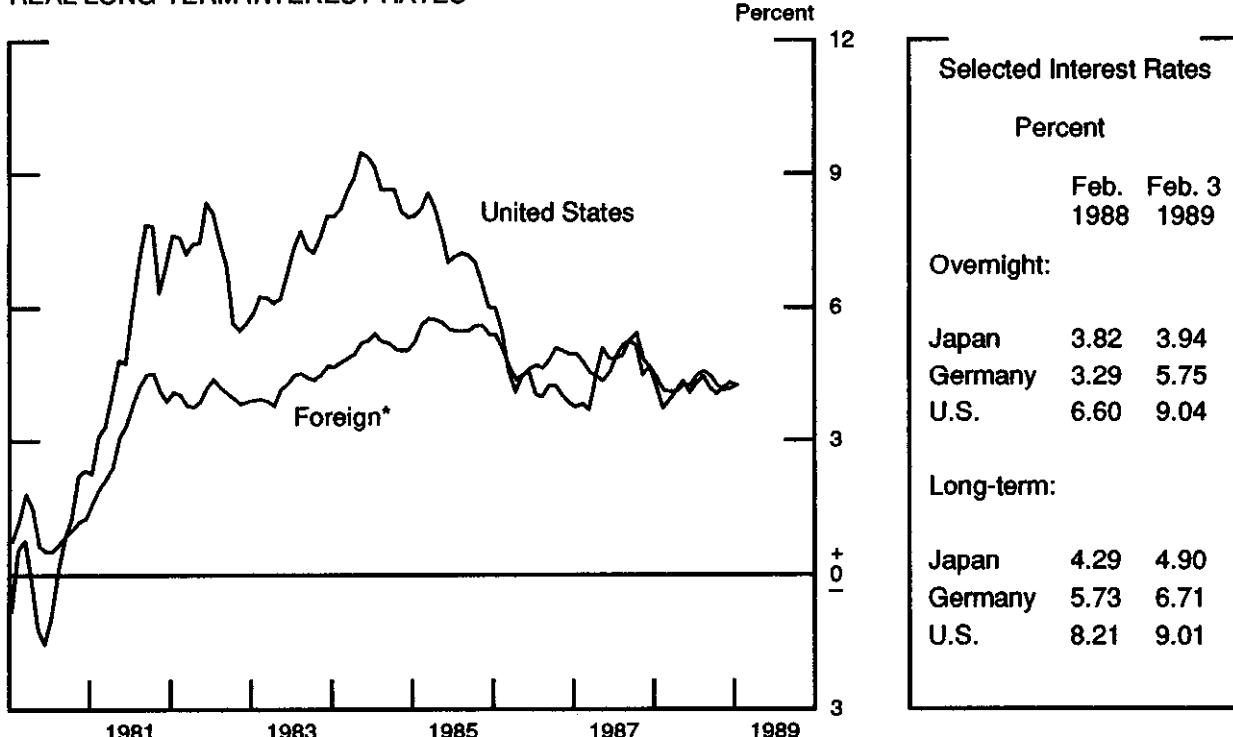
Chart 11

FOREIGN EXCHANGE VALUE OF THE U.S. DOLLAR

Ratio scale, March 1973 = 100



REAL LONG-TERM INTEREST RATES***



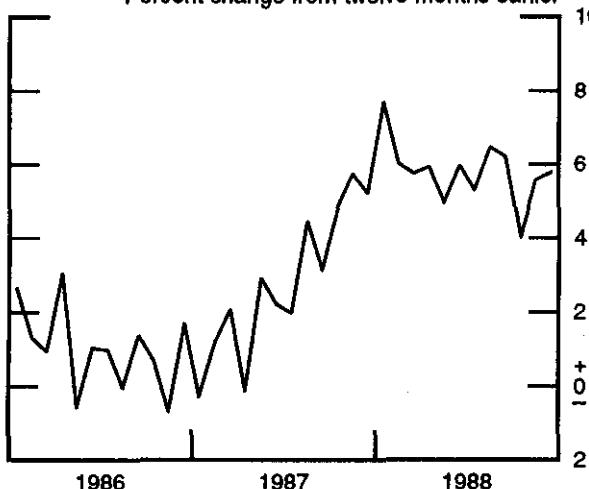
* Weighted average against or of foreign G-10 countries using total 1972-76 average trade.

** Adjusted by relative consumer prices.

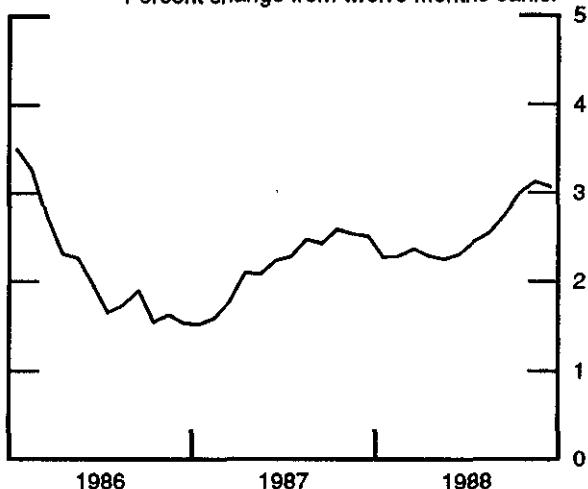
*** Multilateral trade-weighted average of long-term government or public authority bond rates adjusted for expected inflation estimated by a 36-month centered moving average of actual inflation (staff forecasts where needed).

Chart 12

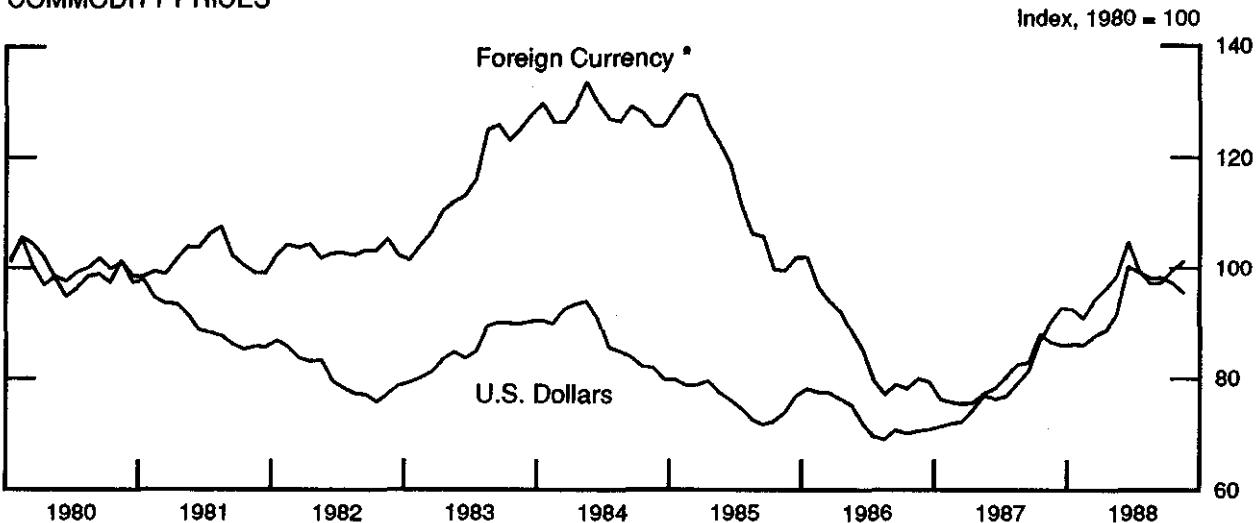
INDUSTRIAL PRODUCTION ABROAD *
Percent change from twelve months earlier



CONSUMER PRICES ABROAD *
Percent change from twelve months earlier



COMMODITY PRICES **



ECONOMIC POLICY ABROAD

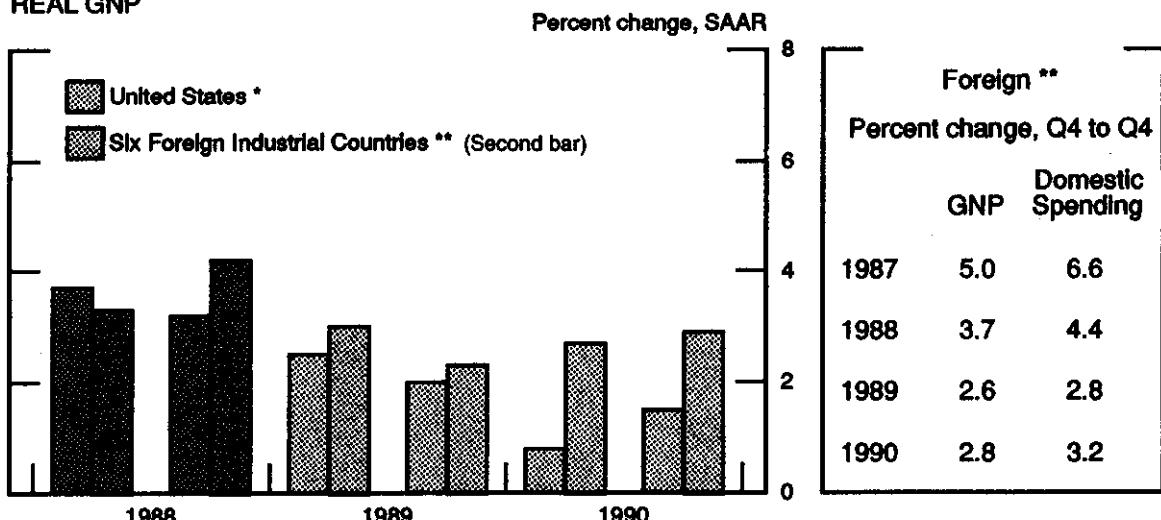
- Increased concern about inflation and capacity pressures.
- Monetary policy expected to tighten further in 1989.
- Fiscal policy generally neutral (tighter in Germany).

* Weighted average for the six major foreign industrial countries using 1982 GNP.

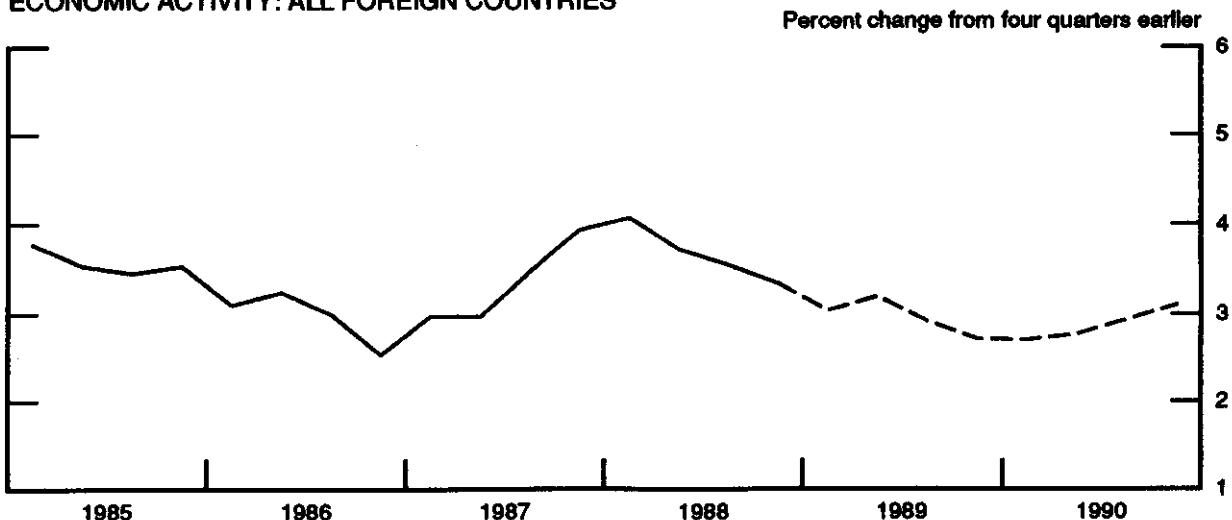
** IMF Index of 39 price series for 34 non-fuel primary commodities.

Chart 13

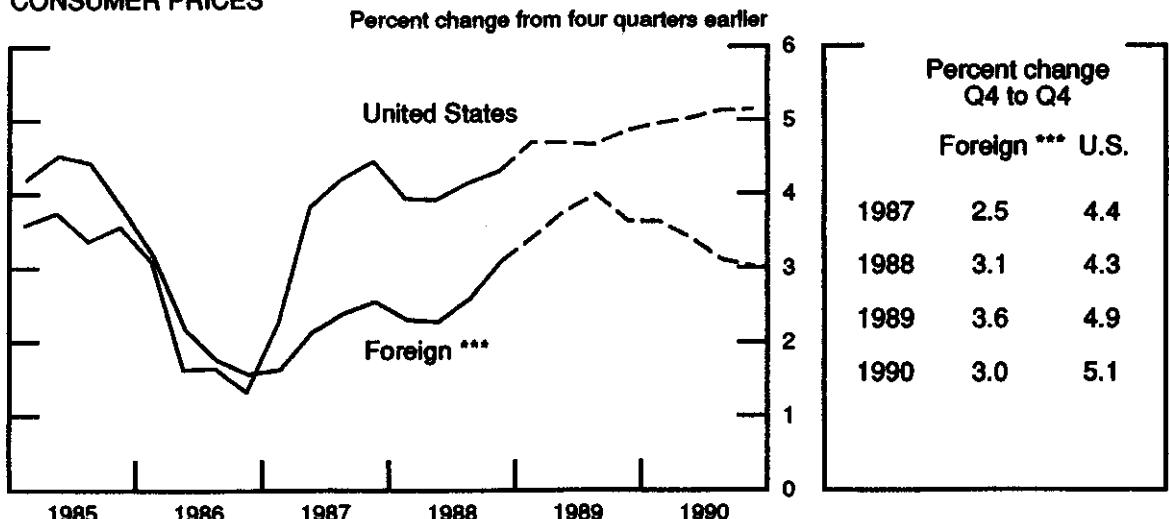
REAL GNP



ECONOMIC ACTIVITY: ALL FOREIGN COUNTRIES **



CONSUMER PRICES



* Excludes drought effects.

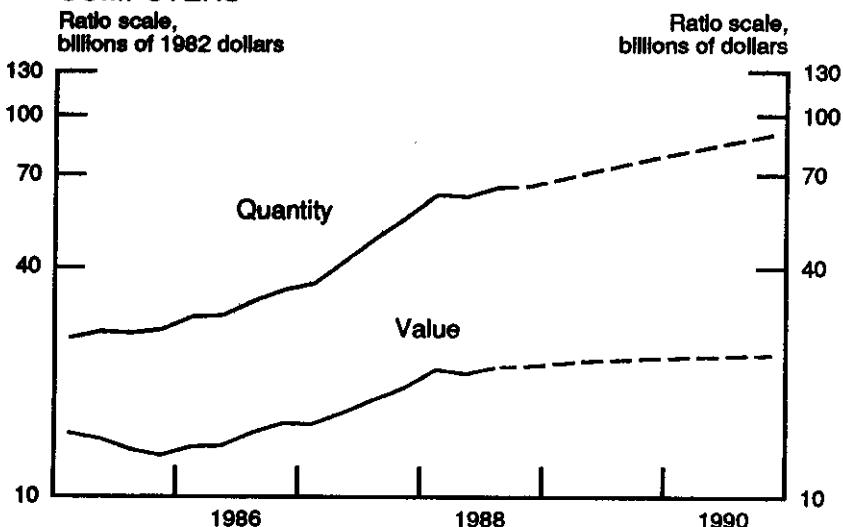
** Weighted average using U.S. non-agricultural exports, 1978-83.

*** Weighted average for six foreign industrial countries using 1982 GNP: Canada, France, Germany, Italy, Japan, and the United Kingdom.

Chart 14

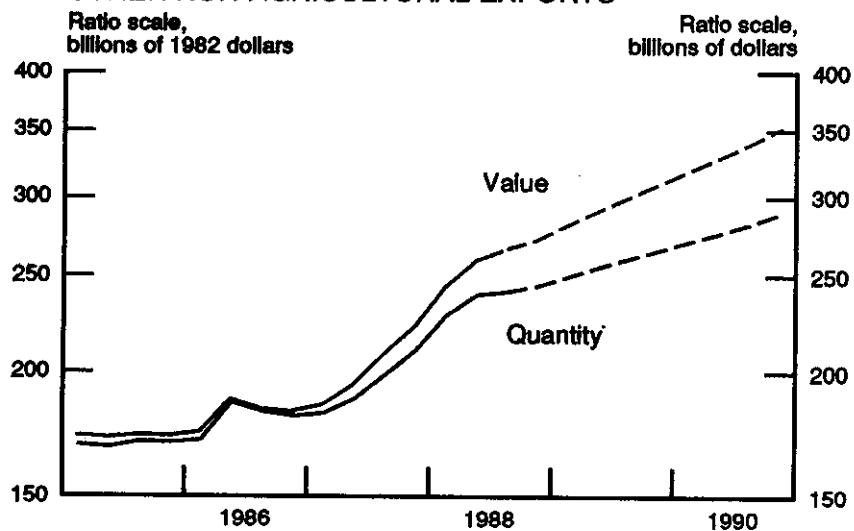
Exports

COMPUTERS

Ratio scale,
billions of 1982 dollarsPercent Change
Q4 to Q4

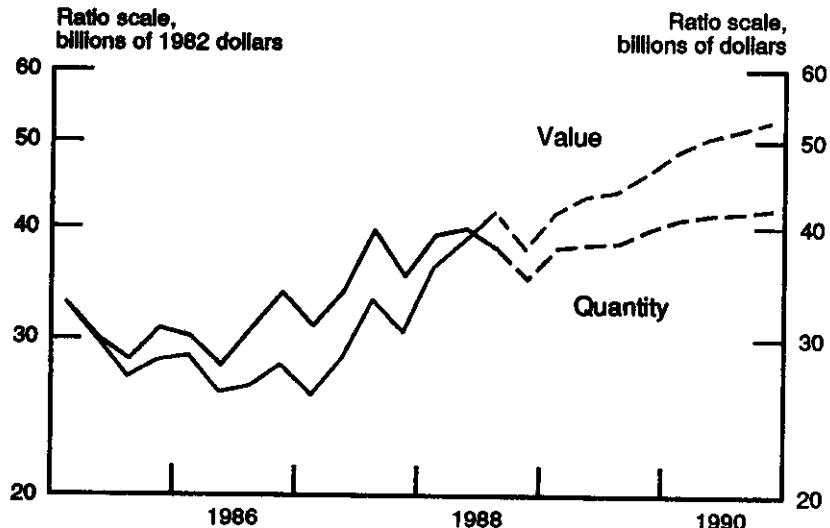
	1988	1989	1990
Value	14	5	2
Price	-6	-12	-12
1982\$	21	18	16

OTHER NON-AGRICULTURAL EXPORTS

Ratio scale,
billions of 1982 dollarsPercent Change
Q4 to Q4

	1988	1989	1990
Value	22	14	14
Price	5	5	4
1982\$	16	9	9

AGRICULTURAL EXPORTS

Ratio scale,
billions of 1982 dollarsPercent Change
Q4 to Q4

	1988	1989	1990
Value	24	22	14
Price	25	7	8
1982\$	-1	14	5

Chart 15

Non-oil Imports

PRICES

	Percent change, Q4 to Q4	
	1987	1988
1. Food	0	5
2. Industrial Supplies	11	13
3. Computers	-20	-6
4. Other Capital Goods	9	5
5. Automotive	4	5
6. Consumer Goods	9	6
7. Other	7	7
8. Total Non-oil	7	7

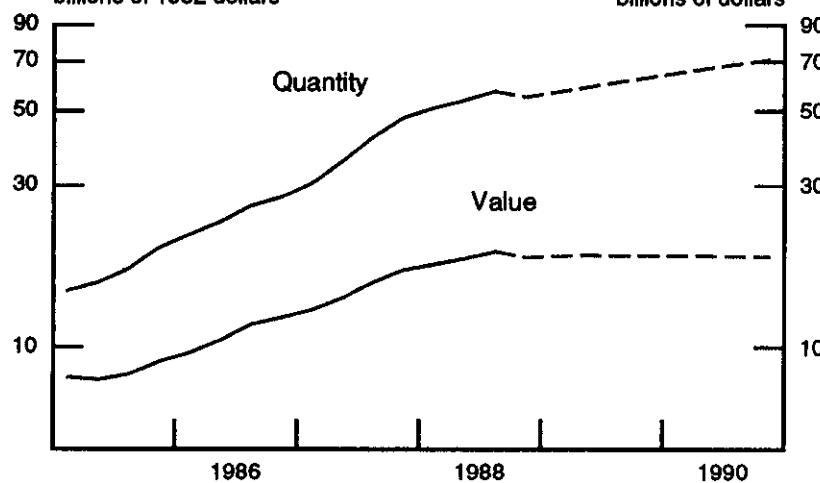
NIPA fixed-weight indexes

QUANTITIES

	Percent change, Q4 to Q4	
	1987	1988
1. Food	2	-5
2. Industrial Supplies	2	-3
3. Computers	73	15
4. Other Capital Goods	10	6
5. Automotive	5	-2
6. Consumer Goods	0	1
7. Other	9	-1
8. Total Non-oil	9	2

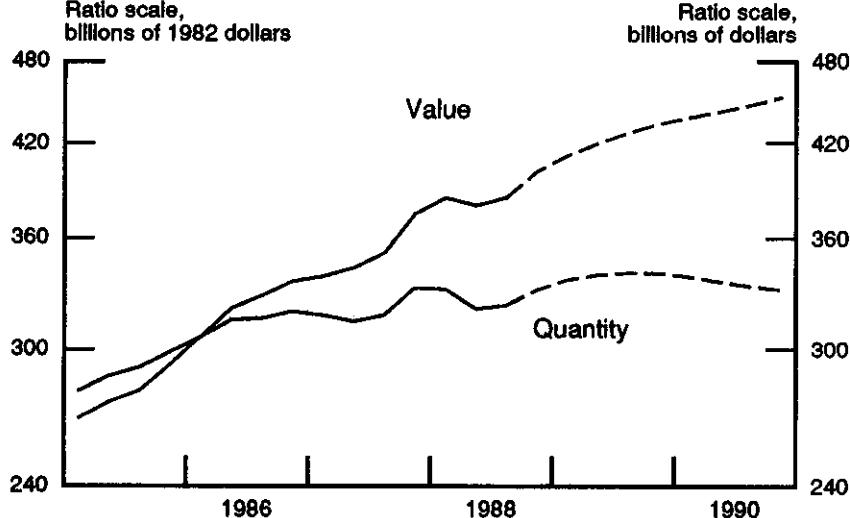
NIPA accounts.

COMPUTERS

Ratio scale,
billions of 1982 dollarsRatio scale,
billions of dollars

	Percent Change Q4 to Q4		
	1988	1989	1990
Value	9	1	-1
Price	-6	-12	-12
1982\$	15	14	13

OTHER NON-OIL IMPORTS

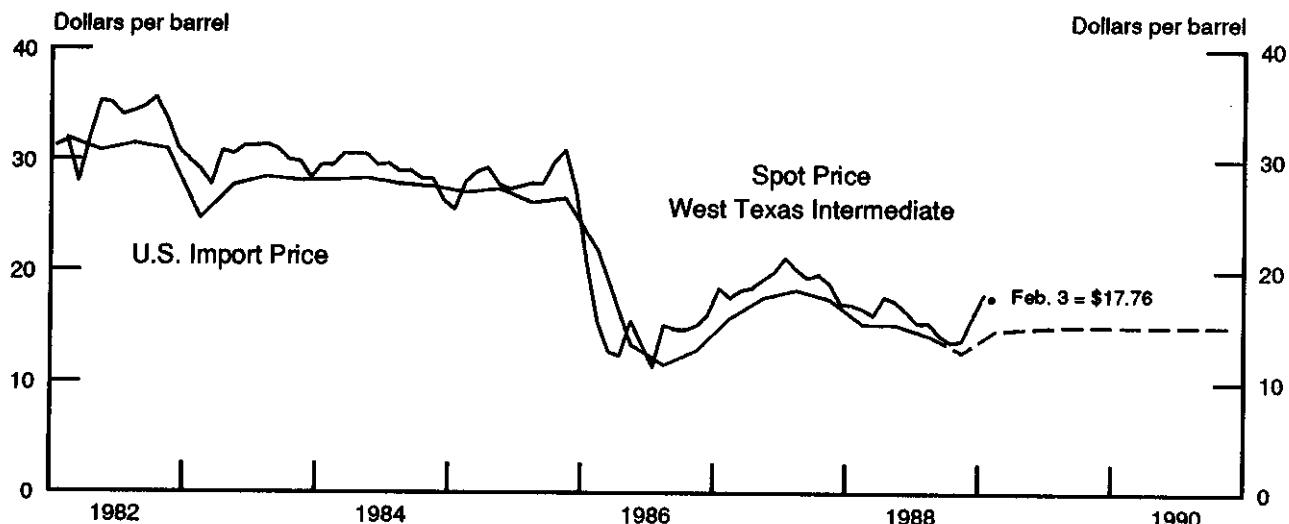
Ratio scale,
billions of 1982 dollars

	Percent Change Q4 to Q4		
	1988	1989	1990
Value	7	8	4
Price	7	5	7
1982\$	0	3	-3

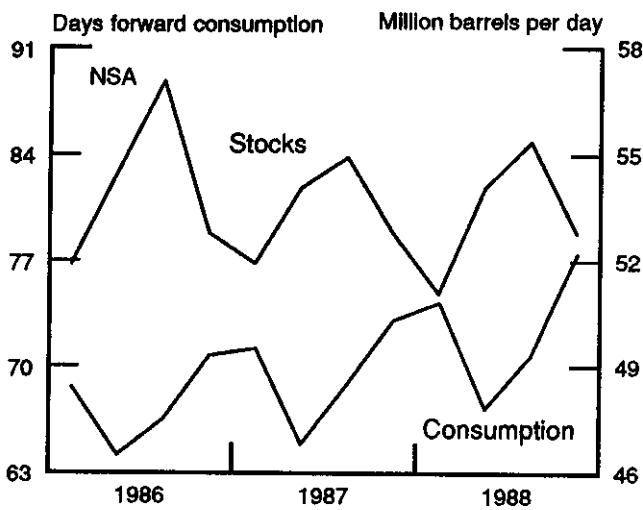
Chart 16

Petroleum and Products

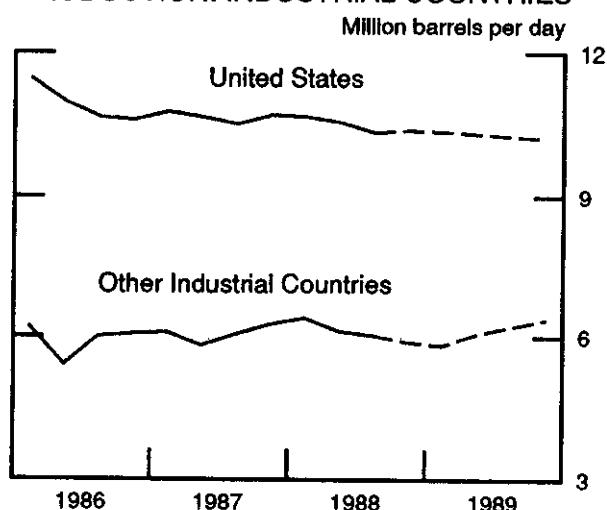
PRICES



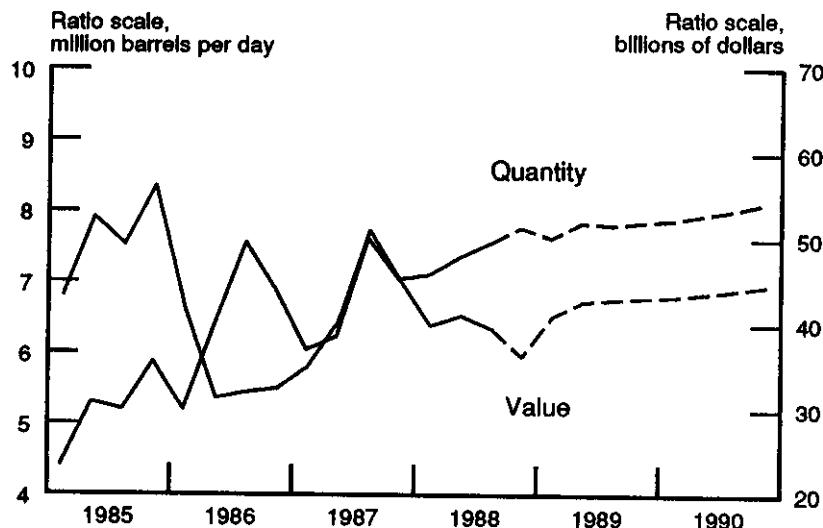
FREE WORLD STOCKS AND CONSUMPTION



PRODUCTION: INDUSTRIAL COUNTRIES



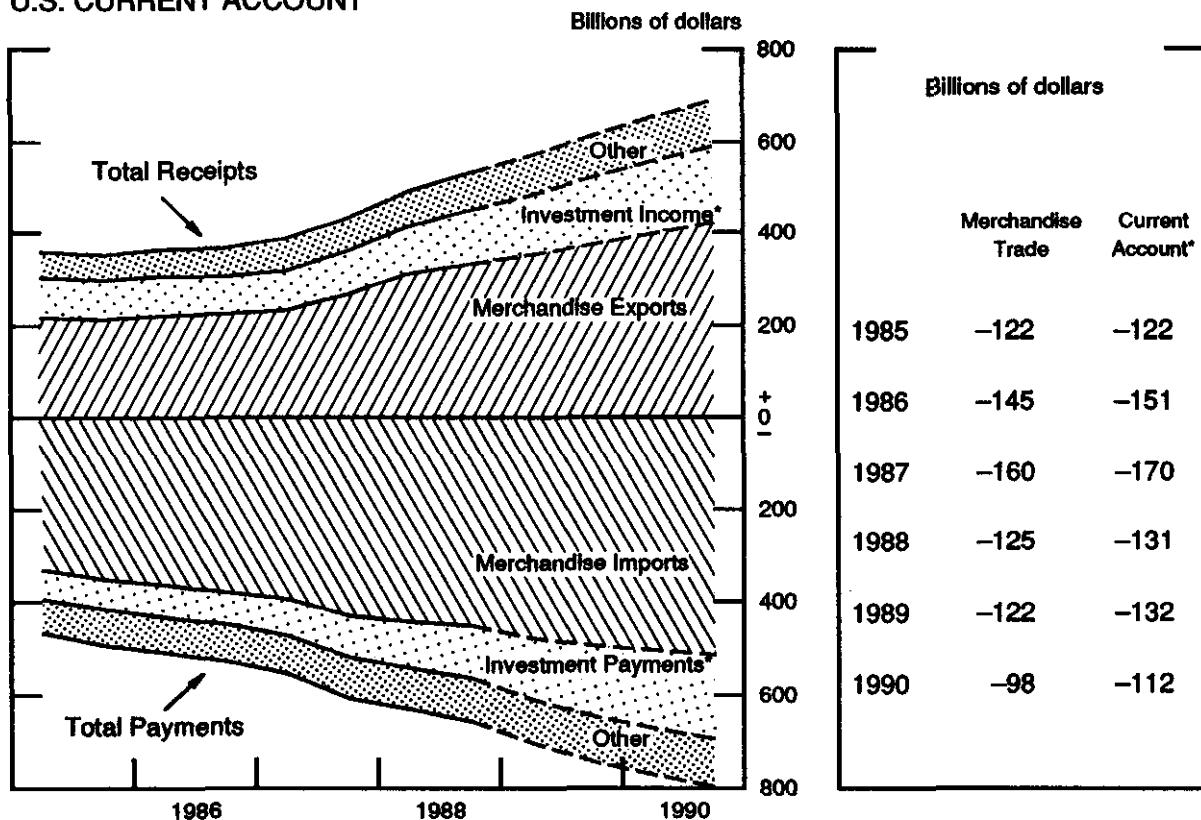
U.S. IMPORTS

Ratio scale,
billions of dollars

	Q4 Level	Price (\$/Barrel)	MBD
1987	17.46	7.1	
1988	12.70	7.8	
1989	15.00	7.9	
1990	15.00	8.1	

Chart 17

U.S. CURRENT ACCOUNT



* Excluding capital gains and losses.

U.S. CAPITAL TRANSACTIONS

	Billions of Dollars, Net Inflows = +			
	1986	1987	1988	1989
1. Private Capital, net	101	96	80	66
2. U.S. Banking Offices ¹	20	47	28	28
3. Bonds and Stocks ^{1 2}	65	28	39	25
4. Direct Investment ^{2 3}	23	16	16	14
5. Other Flows	-7	5	-3	-1
6. Statistical Discrepancy	16	19	16	20
U.S. and Foreign Official Assets	34	55	35	46
7. United States ¹	-2	10	-6	4
8. Other G-10 Countries	31	39	17	25
9. Other Countries	5	6	24	17
Memo:				
10. U.S. and Other G-10 Purchases of Dollars	18	95	2	na
11. Current Account ³	-151	-170	-131	-132

1. The refinancing of foreign governments' military sales debt through the sale of securities guaranteed by the U.S. government has been excluded from changes in U.S. government assets, U.S. purchases of foreign securities, and changes in bank custody claims on foreigners.
 2. Transactions with finance affiliates in the Netherlands Antilles have been excluded from direct investment and added to foreign purchases of U.S. securities.
 3. Excludes capital gains and losses.

Alternative Forecast

- Baseline:** Greenbook forecast extended into 1991 with assumption of no new deficit reduction action in 1991 and a slight easing of short-term interest rates.
- Unchanged Dollar:** Dollar remains at current level; monetary policy adjusts to hold real GNP on baseline path.

	1989	1990	1991
Percent change, Q4 to Q4			
Real GNP, U.S.			
Baseline	3.0	1.1	1.7
Unchanged Dollar	3.0	1.1	1.7
M2			
Baseline	3.5	5.0	6.0
Unchanged Dollar	3.8	5.3	6.5
GNP Prices			
Baseline	4.4	4.7	4.3
Unchanged Dollar	4.4	4.5	3.9
Real GNP Abroad*			
Baseline	2.5	2.6	2.5
Unchanged Dollar	2.6	3.3	3.3
Q4 level			
Current Account			
Baseline	-129	-102	-80
Unchanged Dollar	-130	-119	-112

* Other G-10 countries.

Alternative Forecasts

- Baseline:** Greenbook forecast extended into 1991 with assumption of no new deficit reduction action in FY1991 and a slight easing of short-term interest rates.
- More Money:** Money stock is expanded rapidly enough to hold short-term rates at present levels.
- Tighter Fiscal:** \$27 billion deficit reduction package for FY1990 is expanded to \$50 billion by raising income tax rates.

	1989	1990	1991
Percent change, Q4 to Q4			
Real GNP			
Baseline	3.0	1.1	1.7
More Money	3.5	3.1	4.0
Tighter Fiscal	2.8	1.1	2.0
GNP Prices			
Baseline	4.4	4.7	4.3
More Money	4.5	5.3	6.0
Tighter Fiscal	4.4	4.6	4.3
M2			
Baseline	3.5	5.0	6.0
More Money	4.2	7.5	9.4
Tighter Fiscal	3.5	5.0	6.0
Q4 level, percent			
Unemployment Rate			
Baseline	5.5	6.1	6.5
More Money	5.4	5.2	4.6
Tighter Fiscal	5.5	6.2	6.4
Billions of dollars			
Budget Deficit			
Baseline	159	127	138
More Money	157	100	68
Tighter Fiscal	159	104	105